BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of SIERRA PRODUCTION SERVICE, INC., 0494389, TAXPAYER, AND PRIDE OIL WELL SERVICE COMPANY, 1010269, ASSUMER AND/OR TFANSFPREE	)))))))	No. 88A-0134-DB

Appearances:

For Appellant: Clark A. Knuckey
Assistant Tax Manager

For Respondent: Lazaro L. Bobiles
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Sierra Production Service, Inc., 0494389, Taxpayer, and Pride Oil Well Service Company, 1010269, Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of $24,884, $56,132, and $28,670 for the income years 1978, 1979, and 1980, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appeal of Sierra Production Service, Inc., et al.

The question presented in this case is whether appellant and its wholly owned subsidiary, Sierra Flite Service, Inc. (hereinafter referred to as "Flite"), were engaged in a single unitary business during the years 1978-1980.

Appellant was incorporated in California in 1965 as an oil and gas well-servicing firm located in Bakersfield. It provided a full range of oil and gas well completion, workover, and maintenance services in California and Colorado. Flite was incorporated in California in 1975, and was a general aviation sales and service firm operating out of Meadows Field in Bakersfield. In November 1986, appellant purchased Flite, which by that time was in serious financial trouble. There were two reasons for this acquisition. First, appellant wanted to assure the availability of an air charter service in the Bakersfield area. For several years preceding the acquisition, appellant had used Flite and its predecessor extensively to transport personnel and oil rig service parts to appellant's various oil field servicing locations. Second, Flite had subleased, from appellant, aircraft owned by appellant's principal officers, Michael Hillman and Robert Beasley, and these officers wanted to protect their personal financial interests in the leases.

Following the acquisition and until appellant sold Flite to a third party late in 1980, appellant loaned Flite a total of $500,000 at below-market interest rates and guaranteed at least a substantial part of Flite's loans from other lenders. For 1978, for example, respondent found that approximately 57 percent of all of Flite's debt was held or guaranteed by appellant. Also in 1978, appellant bought buildings and contracted to build new hangar facilities for Flite. Appellant leased these facilities to Flite throughout the appeal period, and apparently also purchased two aircraft which it leased to Flite.

During the appeal years, Flite expanded its business from air charter operations to include the sale of pilot's supplies, plane rentals, and providing flight instruction and aircraft maintenance. Appellant used all of Flite's services to some extent, and it used Flite exclusively to ferry its personnel and spare parts to its well-head servicing locations. Flite's billings to appellant for these services were in the following total amounts: 1978 - $115,303; 1979 - $127,122: 1980 - $100,765. These billings represented 8.63 percent, 6.26 percent, and 6.22 percent of Flite's income for those three years, respectively. On the other side of the ledger, appellant billed substantial charges to Flite for such things as fuel, hangar rental, and aircraft rental. These

charges were in the following amounts: 1978 - $132,627; 1979 - $236,393: 1980 - $122,678. The record does not disclose what percentage of appellant's income these figures represented.

Other interconnections between appellant and Flite during the critical period included common officers and directors, common insurance policies, common auditors and tax and legal counsel, and common profit-sharing plans. In addition, appellant provided all accounting and payroll services for Flite until late 1979, and there were some transfers of office support personnel between the two companies. Finally, although appellant wanted to have an experienced air taxi/charter service executive to manage Flite's operations, it was not able to employ such an individual during the period from April 1978 to early 1980. Conseguently, appellant's president, Mr. Hillman, managed Flite's day-to-day operations during that period.

For the years in question, appellant treated Flite as part of appellant's unitary business and included it in its combined reports. After examining the returns, respondent determined that appellant and Flite were engaged in two different lines of business that were not "functionally integrated." It therefore "decombined" the two companies and issued the deficiency assessments at issue.

If a taxpayer derives income from sources both within and without California, its franchise tax liability is reguired to be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16](1947).)

The California Supreme Court has held that the existence of a unitary business may be established by the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions: and unity of use in a centralized executive force and general system of operation. (Butler Eros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed.991] (1942).) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.) More recently, the United States Supreme Court has emphasized that a unitary

business is a functionally integrated[2/] enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 [77 L.Ed.2d 545], rehg. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983).)

It is axiomatic that business activities conducted in multiple taxing jurisdictions are not automatically unitary merely because they are commonly owned and controlled. Because of constitutional limitations, it is necessary to differentiate between a truly integrated, unitary business, whose income is appropriately apportioned among the jurisdictions in which it is conducted, and a group of commonly owned businesses or activities, the operations of which really have no effect upon one another and the income from which is, therefore, not properly subject to apportionment. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178; Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal.,

2/ Controversy abounds over the meaning of, and the effect to be given to, the term "functional integration," a term which the United States Supreme Court used frequently in its most recent unitary business decisions, and a term which has, not coincidentally, gained great currency in later decisions by lower courts and in our own opinions and decisions regarding unitary combination. In our view, "functional integration" is not a new "test" for the existence of a unitary business (accord Mole-Richardson Co. v. Franchise Tax Board, 220 Cal.App.3d 889 [269 Cal.Rptr.662], mod. 221 Cal.App.3d 425a (1990)), but is merely a descriptive term for what has long been regarded as an inherent characteristic of a unitary business. Nearly half a century ago, Justice Douglas said, in sustaining California's application of the unitary principle to a multistate dry goods wholesaler, "the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated." (Emphasis added.) (Butler Bros. v. McColgan, supra, 315 U.S. at 508.)

For those, in particular, who are concerned about the meaning we ascribe to "functional integration" in the context of so-called "diverse businesses," we have not changed the view we expressed in the Appeal of Hollywood Film Enterprises, Inc., decided by this board on March 31, 1982. There is not a separate unitary test for diverse businesses, and taxpayers engaged in such businesses do not have to satisfy a heavier burden of proof, in order to obtain unitary treatment, than taxpayers engaged in horizontally or vertically integrated businesses. We specifically reaffirm that view today.

Mar. 31, 1982; see also Appeal of Twentieth Century-Fox Film Corporation, 89-SBE-007, Mar. 2, 1989; Appeal of J. B. Torrance, Inc., Cal. St.Bd. of Equal., May 8, 1985; Appeal of Santa Anita Consolidated, Inc., Cal. St. Bd. of Equal., Apr. 5, 1984.

Respondent's position is that appellant and Flite were engaged in two distinctly different lines of business that were not unitary, because there was no "functional integration" between the two. It also suggests that our decisions imply that diverse businesses are presumptively nonunitary. We disagree on both counts.

As we reiterated today (see footnote 2, supra), there is not a separate unitary test for diverse businesses, and it is not necessary to satisfy a heavier burden of proof in order to justify unitary treatment for diverse businesses. Support for this approach is contained in respondent's regulation 25120, subdivision (b), which provides guidance for determining the existence of a single (unitary) trade or business, and which puts diverse businesses with strong central management, and certain other characteristics, on equal footing with affiliated entities engaged either in the same general line of business or in different steps in a large, vertically structured enterprise. A "strong presumption" of unity arises in all three cases. In relevant part, the regulation provides as follows:

> (b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business.' In such cases, it is necessary to determine the business income attributable to each separate tr'ade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.
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> The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as

a whole. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(1) Same type of business: A taxpayer is almost always engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

(2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

(Cal. Code Regs., tit. 18, reg. 25120, subd. (b).)

For some time, it has been apparent that, at the administrative level, respondent has not been applying this regulatory presumption to taxpayers engaged in diverse lines of business. To a considerable degree, respondent has been justifying its refusal to do so by citing a number of our published opinions involving diverse businesses. By our decision in this case today, however, we intend to leave no doubt in anyone's mind that we strongly disapprove of respondent's failure to apply its own regulation. We believe that, fairly read in its entirety, the regulation is consistent with the applicable federal constitutional principles,.?/ and that neither those principles nor our prior decisions in this area justify a conclusion that it is virtually impossible for taxpayers operating diverse businesses to qualify for unitary treatment. (See, e.g., Appeals of Lancaster Colony Corporation, et al., Cal. St. Bd. of Equal., Oct. 10, 1984; Appeal of Pittsburgh-Des Moines Steel Company, Cal. St. Bd. of Equal., June 21, 1983; Appeal of Saga Corporation, Cal. St. Bd. of Equal., June.29, 1982.)

3/ The regulation states, for example, the general principle that "the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole." This languase is not difficult to reconcile with that used by the United States Supreme Court to describe the characteristics of a unitary business which a state might rely upon to justify its tax. For example, the Court noted in Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 5101 (1980), that a state may require unitary apportionment instead of allowing separate geographical accounting, because the latter may fail to account for "contributions to income resulting from functional integration, centralization of management, and economies of scale," since "these factors of profitability arise from the operation of the business as a whole." Similarly, in Container the Court used the terms "integrated enterprise" (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 177, fn. 16) and "functionally integrated enterprise" (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 179) as synonyms for a unitary business, and it also reiterated that "substantial mutual interdependence" is a characteristic of a unitary business (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 179, quoting F.W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 371 [73 L.Ed.2d 8191 (1982)).

In the present case, we think there is sufficient evidence of mutual interdependence and flows of value to establish that appellant and Flite were a single integrated economic enterprise. (See Appeal of Saga Corporation, supra.) For the greater part of the appeal years, appellant's officers managed every aspect of both companies' operations, including day-to-day operating decisions. It is also clear that both corporations were managed in such a way as to benefit each other's business operations. For example, appellant bought both aircraft and hangar facilities which it rented to Flite for use in the latter's business. Flite, on the other hand, was appellant's exclusive air charter service and thereby provided essential support on a regular basis to appellant's well-servicing business. It is also noteworthy that the substantial preferential financial support which appellant provided to Flite not only benefitted the latter, but also furthered the interests of appellant's unitary business by helping make Flite a more dependable source of important services for that business. Thus, this financing did not simply serve the purely investment function of making Flite a more profitable independent asset.

Respondent's reliance in this case on the conclusionary statement that appellant and Flite were not "functionally integrated" illustrates an increasingly common problem in cases like this: a tendency by all parties to rely on labels and conclusionary terms rather than on the evidence itself and what it fairly can be said to establish. Labels are not helpful in justifying either combination or decombination, regardless of who uses them. Unitary combination cases are decided on the basis of specific, concrete evidence,[4/] when

4/ With respect to evidence, taxpayers and their representatives should never lose sight of the facts that proceedings before this board are de novo and that this board and the Franchise Tax Board are two separate entities. The practical meaning of these observations is that a taxpayer who appeals to this board should always submit to us each item of evidence that will support its case, even though that evidence has already been submitted to (and rejected by) the Franchise Tax Board. Our view of the sufficiency and probity of such evidence may well differ from that of the Franchise Tax Board, and taxpayers should certainly not assume that the Franchise Tax Board, which is their adversary before this board, will necessarily provide us with evidence in its possession that favors the taxpayer.

it is available. Unfortunately, in more than a few cases, the appellate record is so lacking in substantive evidence as to require us to resort to the burden of proof in order to resolve those cases. Since the ultimate burden of persuasion normally falls on the taxpayer, it is usually the appellant who suffers when the record is factually inadequate. (See Cal. Code Reqs. tit. 18, req. 5036.)

Finally, a brief discussion of regulation 25120, subdivision (b), is in order. As we stated above, we disapprove of respondent's failure to give effect to the presumption regarding taxpayers engaged in diverse lines of business, and we fully intend to apply that presumption in appropriate appeals before this board. If, for example, a taxpayer is seeking the benefit of that presumption, the presumption will apply if the taxpayer establishes, by specific, concrete evidence, that it had both "strong central management"?/ and "centralized departments for such functions as financing, advertising, research, or purchasing."6/ (Cal. Code Reqs, tit. 18, reg. 25120, subd. (b)(3).) Once those are proven, the presumption of unity applies and the burden of going forward with the evidence shifts to respondent, who will then be obliged to offer concrete evidence sufficient to support a finding that a single integrated economic unit did not exist. If respondent satisfies this burden, then the

5/ What constitutes "strong central management" will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of "common officers or directors" or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in Container. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 180, fn. 19.)

6/ There is no question that the regulation does not contain an all-inclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a "centralized department" requires something weightier than merely alleqinq, for example, that there was a "common accountant" who kept the books for each affiliate. Other trivialities like a "common insurance agent" will likewise be insufficient.

presumption disappears, and the taxpayer will, as in the usual tax case, bear the ultimate burden of persuading us, by a preponderance of the evidence, that the taxpayer's position is correct. (See footnote 3 in Appeal of Saga Corporation, supra.)

For the reasons set forth above, we have concluded that appellant and Flite constituted a single integrated economic enterprise entitled to treatment as a single unitary business. Respondent's action in this matter will, therefore, be reversed.

Appeal of Sierra Production Service, Inc., et al.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Sierra Production Service, Inc., 0494389, Taxpayer, and Pride Oil Well Service Company, 1010269, Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of $24,884, $56,132, and $28,670 for the income years 1978, 1979, and 1980, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 12th day of September, 1990, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, and Ms. Scott present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

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